United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-7633

United States Court of Appeals

FOR THE SECOND CIRCUIT

THE EXCHANGE NATIONAL BANK OF CHICAGO,

Plaintiff-Appellee,

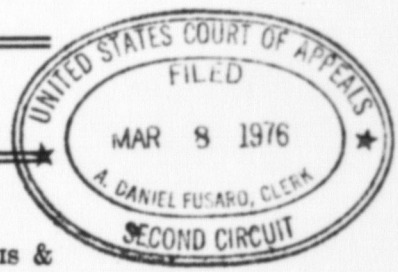
—against—

TOUCHE ROSS & CO.,

Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR APPELLANT



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

THE EXCHANGE NATIONAL BANK OF CHICAGO, Plaintiff-Appellee, -against- TOUCHE ROSS & CO., Defendant-Appellant.	Docket No. 75-7633

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR APPELLANT

Plaintiff Exchange Bank concedes, as it must, that the financial context of the transaction giving rise to the notes here in issue is of crucial importance in determining whether those notes are "securities", and that a note evidencing a commercial loan is not a "security"

(e.g., Pl. Brief 14-15*). However, plaintiff Exchange Bank errs (as did Judge Wyatt below) in contending that the purported "facts" (which are in actuality largely inadmissible hearsay and conclusory and self-serving assertions) and authorities show that the notes do not evidence a commercial loan, and are therefore securities.** As shown below, plaintiff Exchange Bank's analysis does not demonstrate that the notes evidence anything other than an ordinary commercial loan, and its effort to distinguish the concededly controlling authorities is unpersuasive.

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* The reference to "Pl. Brief" is to the brief of plaintiff Exchange Bank. The reference to "Def. Brief" is to the main brief of defendant Touche Ross.

** Plaintiff Exchange Bank erroneously asserts (Pl. Brief 4-5) that defendant Touche Ross has suggested that the affidavits submitted by plaintiff Exchange Bank should not have been considered by Judge Wyatt on the motion to dismiss. In fact, as defendant Touche Ross' main brief points out (Def. Brief 6), defendant Touche Ross had suggested to Judge Wyatt (A219-A220) that discovery be permitted with respect to the jurisdictional issue so that a full record could be made for the determination thereof -- a procedure which clearly would have been the most appropriate one. See, e.g., 5 Wright & Miller, Federal Practice & Procedure §1350 (the Court "may allow discovery to be completed on the issue [of jurisdiction] and a further hearing to be held before ruling on the motion"). In the absence of such discovery, as defendant Touche Ross further noted, any ruling on jurisdiction based on plaintiff Exchange Bank's affidavits could be at most provisional and subject to revision after discovery of all the facts.

I

PLAINTIFF EXCHANGE BANK ERRS IN CONTENDING THAT ITS LOAN TO WEIS WAS NOT A COMMERCIAL LOAN TRANSACTION BUT INSTEAD WAS AN INVESTMENT TRANSACTION

Plaintiff Exchange Bank prefaces its argument on the financial context of the notes here by citing thoroughly familiar authorities on the "flexible" construction which is to be afforded to the federal securities acts in the light of their remedial purposes (Pl. Brief 13-15). However, plaintiff Exchange Bank does not purport to suggest that the authorities which are cited by defendant Touche Ross (Def. Brief 20-27) and which hold that commercial loan notes are not "securities" fail to construe those acts "flexibly" and in light of their legislative purposes. Rather, plaintiff Exchange Bank -- which concedes (Pl. Brief 15) that these authorities are governing -- simply ignores the persuasive reasons they set forth for excluding commercial loans from the concept of a "security" (cf. Def. Brief 26).

Thus, there is no dispute here as to the proper canons of statutory construction. The issue simply is whether the notes here evidence a commercial loan.

With respect to that issue, plaintiff Exchange Bank strives to de-emphasize the substantive factors shown on the face of the notes (e.g., the fact that the notes provide for interest "at a rate per annum. . . which shall be 3% in excess of the prime commercial loan rate" of plaintiff Exchange Bank (emphasis added)), by purporting to look to the "full financial context" to establish its contention that the notes were part of an "investment transaction" and are "securities."* Examination of the matters relied upon by plaintiff Exchange Bank

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* Plaintiff Exchange Bank would turn the situation around by arguing (Pl. Br. 15) that defendant "Touche [Ross] ignores or makes light of those factors [showing financial context] and instead relies almost exclusively on the face of the notes". That argument misses at least three important points emphasized by defendant Touche Ross (e.g., Def. Brief 5). First, the notes themselves are not only part of, but their specific terms reveal the financial context of, the loan transaction. For example, the tying of the interest rate of the "prime commercial loan rate" of plaintiff Exchange Bank shows clearly the intention of both plaintiff Exchange Bank and Weis that the notes evidenced a "commercial loan". Second, since plaintiff Exchange Bank has failed to show that the financial context has any of those aspects which are typical of or go to show the existence of an investment transaction, defendant Touche Ross' position here has required it to point out the negative aspects (that is, the failure to show that the transactions leading to the notes was an "investment" transaction) of plaintiff Exchange Bank's showing. Third, defendant Touche Ross does point to factors outside the notes to demonstrate the "commercial loan" nature of the transaction. One (and only one) example of such other factors is that plaintiff Exchange Bank is a commercial bank concededly in the business of making commercial loans.

in support of that contention shows, however, that they do not support or justify plaintiff Exchange Bank's contention or its constantly-reiterated, conclusory and self-serving assertions that it was an "investor", and that its loan to Weis was an "investment".

A. Plaintiff Exchange Bank Misconceives The Subordination Feature.

Plaintiff Exchange Bank relies primarily upon the subordination feature of the notes to establish that they evidence an "investment" transaction, and are therefore "securities". It commences its discussion of the subordination feature, however, by positing as its basic premise the very conclusion which it would have this Court reach on this appeal, viz., its own conclusory assertions that what Weis offered to subordinated lenders was an "investment opportunity", and that such lenders were therefore "investors" (Pl. Brief 16). It also attempts to inflate the risk associated with any subordinated loan to Weis by asserting (without any record support) that "Weis had reached the limits of unsubordinated indebtedness permitted under New York Stock Exchange Rule 325" and thus had a compelling need for further subordinated loans (Pl. Brief 16).

Plaintiff Exchange Bank then proceeds to totally distort the effect of the subordination feature in an attempt to make the transaction fit its interpretation of the recent Supreme Court decision in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). Thus, focusing on the Court's statement in United Housing Foundation that the premise of a securities transaction is the investor's "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others", plaintiff Exchange Bank argues that because of the subordination feature its ability to "receive a profit" on its loan to Weis depended directly upon Weis' ability to earn a sufficient amount of income, and that the notes are thus "securities" (Pl. Brief 16-17). That argument, however, misses the point of United Housing Foundation, in which the Court expressly defined profits as "capital appreciation . . . or a participation in earnings resulting from the use of investors' funds". 421 U.S. at 852. Here, plaintiff Exchange Bank had no equity interest in Weis and was entitled to no participation in Weis' profits. The only "profit" plaintiff Exchange Bank sought was the interest income (which was not contingent on Weis' earnings) on its loan -- just as did Weis' other

commercial lenders. Cf. C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1359 (7th Cir.), cert. denied, 44 U.S.L.W. 3201 (1975) (in holding that commercial loan notes are not "securities", the Court observed that "[i]n one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest").

Moreover, plaintiff Exchange Bank errs in contending that the subordination feature made payment of principal and interest on the loan dependent on Weis' income, because with respect to that feature the only matter which was significant was Weis' solvency. Neither surplus nor profits were required for the repayment of the loan, and the only contingency which mattered was bankruptcy -- which usually is an adverse development for all creditors, including those whose claims are unsubordinated. Thus plaintiff Exchange Bank's conclusion that it took an "investor's, not a lender's risk" (Pl. Brief 18) is an outright distortion. What it -- and the other banks making subordinated commercial loans to broker-dealers -- took was a subordinated lender's, not an "investor's", risk.

Plaintiff Exchange Bank's statement that it had "no

desire or opportunity to 'use or consume' the notes" (Pl. Brief 18) is utter nonsense, for it can hardly contend that it has either the desire or opportunity to "use or consume" its conceded "normal commercial loan note" (A54, A117). While, as in United Housing Foundation, Inc. v. Forman, supra, the purchaser's desire to "use or consume" the item purchased (such as a cooperative apartment) means that "the securities laws do not apply", plaintiff Exchange Bank certainly errs in contending that the absence of such a desire places within the scope of those laws a transaction (such as a commercial loan) which otherwise is not within that scope. E.g., United Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 849 n. 14 (citing with approval lower court decisions holding that commercial loan notes are not "securities").

The cases cited by plaintiff Exchange Bank on the subordination issue (Pl. Brief 18-24) have already been distinguished by defendant Touche Ross (Def. Brief 39-41), with one exception.* Moreover, plaintiff Exchange Bank's

* The exception is Fischer v. New York Stock Exchange, CCH Fed.Sec.L.Rep. ¶95,416 (S.D.N.Y. January 15, 1976), a decision reported after defendant Touche Ross' main brief was filed. Plaintiff Exchange Bank's speculation as to what was "implicitly recognized" (Pl. Brief 22) in that decision is unconvincing. The "arrangement" that was extended from time to time in that case also included "non-voting stock purchases" which also were "in force for a limited term only". Id. at p. 99,106. Moreover, that case did not involve a subordinated loan made by a commercial bank.

argument based upon those cases clearly proves too much. Plaintiff Exchange Bank's contentions that "the continuing payment of interest [to plaintiff Exchange Bank] depend[ed] wholly on the efforts of the borrower", and that the notes here are manifestly "evidence of indebtedness" (Pl. Brief 20), are equally applicable to all of plaintiff Exchange Bank's commercial loans -- yet plaintiff Exchange Bank expressly concedes that its normal commercial loan notes are not "securities" (Pl. Brief 15).

Plaintiff Exchange Bank also mistakenly relies (Pl. Brief 23), to support its contention that the holding of New York Stock Exchange v. Sloan should be extended to cash loans made by commercial banks, upon Judge Lasker's statement therein that the rules promulgated under Section 6 of the 1934 Act are "intended to protect those who entrust their funds or securities to broker-dealers". 394 F. Supp. at 1310. The error in that contention can simply be observed by noting that the protection of Section 6 also extends to ordinary customers of a broker-dealer who entrust to it the cash in their brokerage accounts. See Rich v. New York Stock Exchange, 379 F.Supp. 1122 (S.D.N.Y. 1974), rev'd on other grounds, 522 F.2d 153 (2d Cir. 1975) (interest on cash balances frozen during

SIPC liquidation may be recoverable as damages by customers under Section 6). Plaintiff Exchange Bank cannot seriously contend that such customers' cash balances are "securities". Indeed, in Sloan, Judge Lasker expressly held that even if the interests of the subordinated lenders there did not constitute "securities", they nevertheless had standing to sue under Section 6. 394 F.Supp. at 1310. Furthermore, as already pointed out by defendant Touche Ross (Def. Brief 40-41), Sloan itself did not involve money loans.

Plaintiff Exchange Bank also erroneously argues that the "economic realities" of its cash loan to Weis are not materially different from the "economic realities" experienced by those who subordinate their existing investment securities portfolios to a broker-dealer (Pl. Brief 23). In the first place, it must be observed that the risks which are involved in the two situations are hardly identical, since the notes here were expressly senior to the obligations of Weis to persons who had subordinated their securities accounts (see Def. Brief at 42 fn.). Moreover, the fact that there may be some similarity in the degree of risk involved is not determinative, because the same

can be said of th comparative risks to holders of debentures of major corporations (such as AT&T) traded on the New York Stock Exchange (which undoubtedly are securities) and to banks receiving notes to evidence commercial loans (which notes concededly are not securities) to those corporations.*

The contention by plaintiff Exchange Bank that its admitted role as a commercial bank making commercial loans is irrelevant here (Pl. Brief 24) is also without merit. See, e.g., Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974) (whether or not plaintiff is "in the business of making loans" is a relevant factor). Plaintiff Exchange Bank, which completely ignores in its brief the role of commercial banks generally in making subordinated loans to broker-dealers (see Def. Brief 35-36), cannot contend that

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* To the extent that New York Stock Exchange v. Sloan and the other cases relied upon by plaintiff Exchange Bank can be read as purporting to hold that all subordinated indebtedness is a "security" irregardless of the financial context and notwithstanding whether such indebtedness results from a commercial loan transaction, those cases are wrong in that they fail to give effect to the "unless the context otherwise requires" language of the statutory definitions and fail to apply the well settled principle that the Court must look to the financial context of each case to determine whether or not a particular note is a "security".

its loan to Weis was an "isolated transaction outside normal commercial circles". Cf. Zabriskie v. Lewis, supra. Plaintiff Exchange Bank's argument (Pl. Brief 24) that the outcome here should be no different than that which would be required if the notes had been "sold to individual investors" is flatly contradicted by the authorities, which hold that the fact that notes are acquired by a commercial lender, and not "sold to individual investors", is an important factor showing that such notes are not "securities". See, e.g., McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Thorp Commercial Corp. v. Northgate Industries, Inc., CCH Fed.Sec.L.Rep. ¶94,929 (D. Minn. 1974).

B. Plaintiff Exchange Bank Confuses "Net Capital" Under NYSE Rule 325 With The Concept Of A "Security".

Plaintiff Exchange Bank's argument that "net capital" under Rule 325 of the New York Stock Exchange ("NYSE") is conceptually the same as a "security" (Pl. Brief 24-27) is based more on semantics than upon analysis. Thus, in its argument on the significance of Rule 325, plaintiff Exchange Bank asserts that the interests of subordinated lenders are "much more like the interests of equity stock-

holders than of commercial creditors" because both subordinated lenders and equity stockholders can recover on their claims "only after all claims of general creditors are fully satisfied" (Pl. Brief 25). The misleading nature of that assertion can be shown simply by observing that it could be just as easily said that the interests of subordinated lenders are "much more like" the interests of general creditors than of equity stockholders, because both general creditors and subordinated lenders are entitled to recover their claims in full before equity stockholders can recover anything.

The point which plaintiff Exchange Bank misses is that the hierarchical ranking of the claims of creditors and shareholders of an enterprise involves virtually a continuum, at every point of which the rights of the particular claimant bear some resemblance to the rights of those ranking just above as well as those ranking just below. The continuum extends from the most fully secured creditor at the one end, to the holders of the common stock at the other. How the various interests are to be grouped or classified depends upon the purpose for which the classification is to be made.

Here, the notes evidencing plaintiff Exchange Bank's loan to Weis, although subordinated to claims of general creditors, were by their express terms senior to the claims of almost all of Weis' other subordinated lenders, including those lenders who had subordinated their securities accounts (see Def. Brief 42 fn.). The clause in the notes providing for such seniority is obviously an indication of some superiority in bargaining position possessed by plaintiff Exchange Bank and not possessed by such other subordinated lenders (for whom New York Stock Exchange v. Sloan may conceivably be in point). The question of whether the federal securities laws were intended to reach individual transactions negotiated directly with individual commercial lenders resulting in individual loans granting special provisions for seniority over other claims cannot be answered simply by asking whether the loan or loans in question were classified as "net capital" for purposes of NYSE Rule 325. The purpose of Rule 325 is only to protect the customers of a broker-dealer by insuring that it maintains a position of sufficient liquidity. See, e.g., Don D. Anderson & Co. v. Securities & Exchange Commission, 423 F.2d 813, 816 (10th Cir. 1970). Plaintiff Exchange Bank's loan to Weis, because of the subordination provision, was in-

cluded in Weis' "net capital" under Rule 325 only because the subordination provision resulted in the protection to Weis' customers required by that rule -- not because of any judgment that a bank in the position of plaintiff Exchange Bank was "purchasing" a "security" and needed the protection afforded by the federal securities laws.

In addition to making unwarranted inferences from the words "net capital", plaintiff Exchange Bank also suggests that "aggregate indebtedness" under Rule 325 is somehow synonomous with the "commercial loan" concept used in determining whether notes are "securities" (Pl. Brief 24, 26). However, mere reference to the definition of "aggregate indebtedness" (Pl. Brief, Appendix A, second page) shows that it is a term of art having a complex definition with many exceptions, including exceptions for items, such as loans adequately collateralized by exempted securities, which normally would be commercial loans. As in the case of "net capital", therefore, it is clear that plaintiff Exchange Bank's misuse of the "aggregate indebtedness" concept results from its ill conceived attempt to use the terminology of NYSE Rule 325 to provide the definition for a "security" under the federal securities laws.

Plaintiff Exchange Bank's misinterpretation of the headings on Weis' balance sheets also results from a similar confusion of "net capital" under Rule 325 with "capital" in the sense of an equity security. The applicable provision of Rule 325 provided for -- and Weis' financial statements showed -- subordinated liabilities "preceding [i.e., not part of] net worth or capital" on Weis' balance sheet (Def. Brief 45; see also, e.g., A124).*

C. Plaintiff Exchange Bank Errs In Contending That Its Alleged Motivation In Making The Weis Loan Shows That The Loan Was An Investment.

In its attempt to turn the notes here into "securities", plaintiff Exchange Bank relies on an alleged motivational factor, viz., its alleged expectation that Weis would deposit funds in and clear funds through plaintiff Exchange Bank's Tel Aviv branch (Pl. Brief 27-30). As pointed out by defendant Touche Ross (Def. Br. 45-46), however, that

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* This also shows the lack of merit in plaintiff Exchange Bank's contention that "subordinated notes were treated by Weis as representing capital investments" (Pl. Brief 11).

Plaintiff Exchange Bank also errs in contending that "[t]he last thing Weis wanted from Exchange National Bank was an ordinary commercial loan" (Pl. Brief 27). That contention not only is unsupported by any reference to the record, but it merely begs the question to be determined here.

alleged expectation was not the expectation of a substantial benefit not usually anticipated and obtained by commercial banks in their usual commercial loan dealings.

Plaintiff Exchange Bank argues that, contrary to defendant Touche Ross' view on this matter, plaintiff Exchange Bank's alleged expectation exceeded those of the ordinary commercial lender; but to support its own view it relies only on unspecific and conclusory assertions such as that the transaction would be to the "mutual benefit" of both it and Weis, and that the transaction "would spur a closer relationship" between them leading to "continuous cooperation and expansion" (Pl. Brief 28-29). Plaintiff Exchange Bank also suggests that its alleged expectation that customers of Weis would clear funds through plaintiff Exchange Bank distinguishes its motives from those of other commercial lenders. However, plaintiff Exchange Bank suggests nothing to show that it, and other commercial lenders, do not in the usual course of business anticipate and obtain the benefit of routine banking transactions with customers, suppliers, employees and others transacting business with their commercial loan customers. In short, if plaintiff Exchange Bank's alleged expectation makes it an "investor", every commercial bank could easily

assert that it "invests" in its commercial loan customers -- and could seek to invoke the federal securities laws if the repayment of its commercial loans turned out to be problematical.

Plaintiff Exchange Bank attempts to lend substance to its contention that its alleged motive evidences the purported investment nature of the transaction by asserting that Mr. Lippe, who negotiated the loan on behalf of the Bank, was an officer with responsibilities over the Bank's investments (Pl. Brief 29) -- a proposition for which there is no support in the record.* Moreover, plaintiff Exchange Bank relies on form exclusively, and not substance, in emphasizing the identity of the party (Weis) which prepared the form of the note as being "[p]erhaps the most significant fact" concerning the transaction (Pl. Brief 29-30;

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* Mr. Lippe's affidavit does state that plaintiff Exchange Bank accepts investment opportunities, and that Mr. Lippe helped guide the Bank on policy matters such as geographical and functional expansion of the Bank's business (which concededly includes the making of commercial loans), but his affidavit carefully refrains from asserting that he was an investment officer (A51-A52). Although plaintiff Exchange Bank now asserts that Mr. Lippe's "duties did not involve negotiating or handling commercial loans" (Pl. Brief 29), that assertion conflicts with the frank admission in his affidavit that he had at least "limited contact with that aspect of the Bank's functioning [i.e., the activities of the normal commercial loan staff]" (A52).

cf. Def. Brief 31 fn.).* Plaintiff Exchange Bank's reliance on such insubstantial matters only serves to further emphasize its efforts here to ignore the significant and substantial aspects of the transaction which are revealed by the notes -- for example, the fact that the notes expressly provided for interest computed upon the basis of "the prime commercial loan rate" of plaintiff Exchange Bank (see, e.g., A33).

D. Plaintiff Exchange Bank Errs In Contending That "Similar Securities" Were Offered To "Other Potential Investors".

Plaintiff Exchange Bank erroneously asserts that the notes here are "securities" because the notes were subordinated to claims of general creditors, and that there were over fifty subordinated lenders who were creditors of Weis (Pl. Brief 30-32). It makes that assertion notwithstanding the obvious and significant differences in the terms of the notes here (which were senior to the claims of all but a very few of the other subordinated

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* Perhaps inadvertently, plaintiff Exchange Bank's statement of the facts here erroneously asserts that "the notes were executed not on the Bank's own forms, but on the forms prepared and delivered by Touche"(emphasis added) (Pl. Brief 8). Plaintiff Exchange Bank probably intended to say "Weis", and not "Touche" (see Pl. Brief 29, A54).

creditors), and in the context of the transaction giving rise to the notes (e.g., that plaintiff Exchange Bank was a commercial lender making a cash loan, whereas most of the other subordinated lenders were investors who subordinated the investment securities in their brokerage accounts with Weis).

Plaintiff Exchange Bank also ignores the undisputed fact that the specific terms of the particular, individual transaction here were negotiated in face-to-face dealings between the highest echelon of officers of both parties to the transaction. Instead, plaintiff Exchange Bank, to support its contention that similar notes were offered to "other potential investors", relies upon unsupported hearsay statements concerning Weis' alleged intention to widely offer such similar notes, as well as upon unfounded speculation as to "investments which were offered to [completely unidentified and perhaps imaginary] additional offerees who declined the opportunity to purchase" (Pl. Brief 31-32). Such hearsay and speculation are insufficient to establish that the notes are "securities" and that the District Court has subject matter jurisdiction of plaintiff Exchange Bank's alleged claims.

The record here shows that in fact there were no more than a handful of other commercial lenders who entered into transactions which in reality (and taking all pertinent factors into consideration) were similar in any significant sense to plaintiff Exchange Bank's loan to Weis. On that record, plaintiff Exchange Bank's contentions with respect to the purported offering of the notes are erroneous.

II

PLAINTIFF EXCHANGE BANK'S EMPHASIS ON ITS USUAL COMMERCIAL LOAN NOTE EXALTS FORM OVER SUBSTANCE

Defendant Touche Ross has shown (Def. Brief 28-33) that the purpose and substance of the loan by plaintiff Exchange Bank to Weis were the same as the purpose and substance of the "usual" commercial loans made by plaintiff Exchange Bank. Plaintiff Exchange Bank attempts to obscure that fact by dwelling in its brief upon largely immaterial differences between the notes evidencing the Weis loan and the "usual" commercial loan note used by plaintiff Exchange Bank (Pl. Brief 33-36).

Thus, for example, plaintiff Exchange Bank emphasizes that the notes evidencing the Weis loan had certain restrictions on transferability which are not contained in plaintiff Exchange Bank's usual commercial loan note (Pl. Brief 34; A55). Clearly, those restrictions would be of significance here only if they were characteristics usually associated with "securities". As shown in defendant Touche Ross' main brief (pp. 43-44), those restrictions are not such characteristics. Defendant Touche Ross did not, as plaintiff Exchange Bank erroneously suggests (Pl. Brief

34), mean by that showing to imply that "limits on transferability preclude denomination as a security", but rather to demonstrate that plaintiff Exchange Bank errs in relying upon those restrictions in attempting to show that the notes are "securities".

Similarly, plaintiff Exchange Bank points to the maturity date of the notes, which after an initial term were due six months after receipt of written demand from plaintiff Exchange Bank (Pl. Brief 36). Plaintiff Exchange Bank makes no showing that this provision is characteristic of a "security". Plaintiff Exchange Bank's own "usual" commercial loan note is payable on demand (A117), while in contrast it would indeed be odd for the typical debt security traded in the securities markets to contain any form of demand feature. Again, defendant Touche Ross does not contend that a demand feature necessarily precludes denomination of a note as a "security", but rather that plaintiff Exchange Bank errs in relying on the particular demand feature of these notes to show that they are "securities."

Likewise, plaintiff Exchange Bank makes no showing that the provisions in the notes concerning prepayment and the defense of actions in certain circumstances (Pl.

Brief 34-36) are significant or material, or that they are characteristics usually associated with "securities".

Plaintiff Exchange Bank also relies on the subordination provision (the limited significance of which is discussed above, pp. 5-12, supra), which does not appear in plaintiff Exchange Bank's "usual" commercial loan note (A117). However, in view of plaintiff Exchange Bank's admitted "lack of prior experience in connection with brokerage house subordinated notes" (A52), the absence of such a provision from its "usual" commercial loan note is immaterial. Significantly, plaintiff Exchange Bank fails to respond to the point (Def. Brief 35-36) that subordinated loans to broker-dealers are made by commercial banks generally as part of their commercial loan business.

III

PLAINTIFF EXCHANGE BANK ERRS IN ASSERTING THAT IT HAS DISTINGUISHED THE CONCEDEDLY CONTROLLING AUTHORITIES RELIED UPON BY DEFENDANT TOUCHE ROSS

Plaintiff Exchange Bank's attempt (Pl. Brief 37-43) to distinguish the authorities relied upon by defendant Touche Ross (Def. Brief 20-26), which plaintiff Exchange Bank concedes are controlling here (Pl. Brief 15, 37), is, like the rest of plaintiff Exchange Bank's argument, premised

basically on its own self-serving, conclusory and erroneous assertions such as that it had an "investment motive" in making the Weis loan, that the loan was an "investment" and that it was an "investor". In addition, plaintiff Exchange Bank relies upon distinctions which the authorities hold are immaterial, and upon a misinterpretation of the criteria mentioned in the authorities.

Thus, in attempting to distinguish Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974), plaintiff Exchange Bank relies upon the duration of the notes (6 months in Bellah, longer here), a factor which the cases hold to be clearly immaterial where the notes evidence a commercial loan. See McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490, 494-495 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Zeller v. Bogue Electric Mfg. Co., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. 908 (1973) (quoted in Def. Brief at 20). Similarly, plaintiff Exchange Bank's contention that it is significant that Bellah dealt with the renewal of an existing loan (whereas the notes here evidence a new loan) is belied by an authority cited by plaintiff Exchange Bank itself. See Fischer v. New York Stock Exchange, supra, CCH Fed.Sec. L.Rep. ¶95,416, at p. 99,106.

Plaintiff Exchange Bank also tries to distinguish Bellah, as well as Thorp Commercial Corp. v. Northgate Industries, Inc., supra, on the purported ground that plaintiff Exchange Bank "looked for its profit to 'the successful operation' of the Weis enterprise" and "hoped to participate in the profits of Weis" (Pl. Brief 38, 40). However, as demonstrated above (pp. 6-7, 16-19, supra), plaintiff Exchange Bank had no equity interest in Weis and was entitled to no participation in Weis' profits, the only real "profit" to be obtained by plaintiff Exchange Bank was the interest on the loan, and plaintiff Exchange Bank's allusion to other purported "profits" is a conclusory mischaracterization.*

Plaintiff Exchange Bank also attempts to distinguish McClure, by arguing that because Weis dealt in securities and other "investment assets", and the proceeds of the loan allegedly were to enable Weis to expand that business, Weis "obtain[ed] investment assets . . . in exchange for its notes" (Pl. Brief 39). That argument misses the point of McClure entirely. The business purpose of the loan to Weis,

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*As noted at the outset of this discussion (p. 24 , supra), and as demonstrated in detail in the earlier sections of this reply brief (pp. 16-21 , supra), plaintiff Exchange Bank engages in similar self-serving, conclusory and erroneous mischaracterizations when it attempts to distinguish the controlling authorities by assertions that it had purported "investment purposes" in making the loan, and that "similar" obligations were "offered" to "a large group of potential investors" (Pl. Brief 38, 39, 40).

as defendant Touche Ross has demonstrated in detail, is entirely consonant with a commercial loan, and does not show that the notes are "securities" (see Def. Brief 31-33). Moreover, when the Court in McClure spoke of a corporation "obtain[ing] investment assets . . . in exchange for its notes", it had in mind transactions where the consideration for the issuance of the notes was investment assets -- e.g., transactions functionally similar to a merger or business combination. See, e.g., Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971) (corporation issued promissory notes in exchange for assets of film processing and optical businesses) (cited in McClure, 497 F.2d at 494, in support of the Court's statement of principle here under discussion). The fact that Weis allegedly was to use the proceeds of the loan from plaintiff Exchange Bank to acquire additional securities neither comes within the principle discussed in McClure, nor constitutes a reason for holding that the notes evidencing the loan are "securities". See City National Bank v. Vanderboom, 290 F.Supp. 592, 608 (W.D.Ark. 1968), aff'd, 422 F.2d 221 (8th Cir.), cert. denied, 399 U.S. 905 (1970).*

* In C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, the Seventh Circuit stated that "notes given by corporate organizers for bank loans to purchase the corporation's capital stock were held [in Vanderboom] not to be securities". 508 F.2d at 1354.

Plaintiff Exchange Bank's criticism (Pl. Brief 40-41) of defendant Touche Ross' reference to the Uniform Commercial Code definition of a "security" (which defendant Touche Ross frankly acknowledged was not a controlling, but only a pertinent, factor) is entirely unjustified. This can most clearly be seen by noting that, although plaintiff Exchange Bank asserts that "Touche cites not a single case nor commentator which suggests that the definition of a security under the federal securities law is dependent in the slightest upon the U.C.C. definition" the same student comment upon which plaintiff Exchange Bank purports to place great emphasis (Pl. Brief 42), expressly points out that "[t]he Code definition is . . . useful as an indication of 'what character the instrument is given in commerce' [citing the cases cited at Def. Brief 38]". See Comment, Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?, 52 Neb. L. Rev. 478, 519 n. 161 (1973).

Moreover, plaintiff Exchange Bank errs in suggesting (Pl. Brief 41-42) that the six possible criteria derived from that student comment were endorsed as "tests" by the Seventh Circuit in C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, in which the Court in fact simply stated that although such criteria were "helpful", "each

case . . . requires its own decision based upon its own facts". 508 F.2d at 1368. Furthermore, plaintiff Exchange Bank's purported analysis based upon the six criteria (Pl. Brief 42-43) is a gross distortion of both the facts and the applicable legal principles. Specifically:

(1) Plaintiff Exchange Bank's contention with respect to how the notes were "characterized in the business community" (Pl. Brief 42) is premised on its assumption -- the erroneous nature of which has already been demonstrated (pp. 12-16 , supra) -- that "net capital" as defined by NYSE Rule 325 is conceptually the same as a "security". In fact, the record is entirely devoid of any evidence that the notes here are "characterized in the business community" as "securities".*

(2) Plaintiff Exchange Bank's reliance (Pl. Brief 42-43) on the fact that the notes were to be used allegedly "for the general financing and expansion of Weis' securities enterprise" is misplaced. See, e.g., Bellah v. First Nat'l Bank of Hereford, supra, 495 F.2d at 1113 (notes evidencing

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* If Judge Wyatt's order were to be affirmed here, and the notes were to be characterized by this Court as "securities", with the result that bank loans such as the one here would therefore be subject also to the registration requirements of the 1933 Act (see Def. Brief 26), the business community doubtless would indeed be astounded.

loans "intended to aid the [borrowers] in the operation of their livestock business" were not "securities"). Indeed, plaintiff Exchange Bank's own "usual commercial loan note" expressly states that

> "The [borrower] hereby represents that the sole purpose of this loan is for the carrying on of, or acquiring, a business, and that the proceeds of the loan will be used solely for such business purposes" (emphasis added) (A117).

(3) Repayment of principal and interest were not, as plaintiff Exchange Bank again erroneously states (Pl. Brief 43), "contingent". In fact, Weis' obligation to repay the notes was unconditional (see pp. 6-7 , supra; see also Def. Brief 29-30).

(4) The number of similar notes involved (only a few, held by no more than a handful of commercial lenders), and the amount of the loans, were entirely consistent with a commercial banking, rather than a securities, setting, contrary to plaintiff Exchange Bank's assertions (Pl. Brief 43).

(5) Contrary to plaintiff Exchange Bank's suggestion (Pl. Brief 43), there is no evidence that the maturity provisions in the notes are characteristic of "securities" (see p. 23 , supra).

(6) The notes were properly listed on Weis' balance sheet as subordinated indebtedness, and not, as plaintiff Exchange Bank asserts (Pl. Brief 43), as part of Weis' "capital structure" (see pp. 12-16, supra).

Conclusion

For the foregoing reasons, and the reasons set forth in the main brief of defendant Touche Ross, the order appealed from should be reversed and the complaint and this action dismissed for lack of subject matter jurisdiction.

Respectfully submitted,

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